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No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

BRIEF AMICUS CURIAE OF SHELL PETROLEUM N.V.

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BRIEF AMICUS CURIAE OF SHELL PETROLEUM N.V.

PRELIMINARY STATEMENT

Shell Petroleum N.V. files this brief *amicus curiae* with the consent of both parties in order to put before the Court certain views as to whether the California franchise tax may be applied to the income of foreign affiliates of corporate taxpayers doing business in California through the combination of the income of that taxpayer with that of its foreign affiliates and the apportionment of that combined income to California. The constitutionality of including the income of a foreign subsidiary of a domestic corporation in the unitary formula was ruled upon by the Court of Appeal for the State of California in *Container Corp. of America v. Franchise Tax Board,* 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981).

While the *Container* case arises in the context of the Franchise Tax Board's combination and apportionment of the income of foreign subsidiaries of a domestic corporation, the Franchise Tax Board has also taken the further step of attempting to tax the income of a domestic company's foreign parent and the parent's worldwide subsidiaries and affiliates. These attempts by the Franchise Tax Board pose even more compelling constitutional arguments against the application of combination and apportionment of foreign source income than those made here by the appellant, Container Corporation of America ("Container Corporation"), and raise certain additional issues, not present here, concerning whether such attempts violate United States treaties and international conventions. Those constitutional and treaty issues have been raised in an action currently pending in the United States District Court for the Northern District of California, *Shell Petroleum N.V. v. Mary Ann Graves, et al.*, No C 81 4302 MHP (N.D. Cal. filed Nov. 4, 1981).

INTEREST OF AMICUS CURIAE

Shell Petroleum N.V. is a company of The Netherlands and is accorded special rights and protections by the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands, the United States Netherlands Double Taxation Convention of 1948, as amended, and general principles of international law. Shell Petroleum N.V. is also accorded certain rights and protections under the United States Constitution both directly and by virtue of the "national treatment" guarantees of both the Treaty of Friendship, Commerce and Navigation and the Double Taxation Convention. These rights and protections may be affected by the decision herein.

Shell Petroleum N.V. has its principal place of business at The Hague. Sixty percent of the equity shareholding in Shell Petroleum N.V. is held by the Royal Dutch Petroleum Co., a company incorporated in The Netherlands. The remaining 40

percent is held by The "Shell" Transport and Trading Company, Public Limited Company, a company incorporated in England.

Shell Petroleum N.V. and an affiliated company, The Shell Petroleum Company Limited, together hold, directly or indirectly, the investments representing interests in the over 900 other Royal Dutch/Shell companies operating in over 100 countries. Included among Shell Petroleum N.V.'s holdings are Shell Oil Company ("Shell Oil") and Scallop Nuclear Inc. ("Scallop Nuclear"). During the period 1967 through 1976 for Shell Oil and 1973 through 1976 for Scallop Nuclear, those two companies engaged in business in California and were subject to the California corporate franchise tax. For those periods of time, the Franchise Tax Board ("the FTB") has applied the franchise tax unitary formula so as effectively to tax not only the income of Shell Oil and Scallop Nuclear, but also the income of their foreign parent, Shell Petroleum N.V., and all of its subsidiaries and affiliates, which comprise the more than 900 Royal Dutch/Shell companies operating worldwide.

As a result of that conduct, Shell Petroleum N.V. has filed an action against the members of the FTB of the State of California in the U.S. District Court for the Northern District of California. (Nov. 4, 1981, No. C 81 4302 MHP). Shell Petroleum N.V. claims that the FTB's application of the corporate franchise tax to the combined and apportioned income of the parent of Shell Oil and Scallop Nuclear and the more than 900 other Royal Dutch/Shell companies violates certain provisions of the two treaties between the United States and The Netherlands, the U.S. Constitution, and general principles of international law. Shell Petroleum N.V. has moved for summary judgment and the FTB has moved to dismiss. The District Court heard oral argument on both motions on June 1, 1982, and they are presently sub judice.

As a foreign parent company whose income, together with that of its affiliates and subsidiaries, has been combined, apportioned and then taxed by the FTB through California's practices of worldwide combination and apportionment, Shell Petroleum N.V. has a special interest in the issues presented by

Container Corporation's appeal to this Court. Because it is a foreign parent company, and because it is entitled to rights and protections under U.S.-Netherlands treaties and international law, as well as the Constitution, Shell Petroleum N.V. believes that it can present views not heretofore expressed which may be of use to the Court in resolving the issues presented.

Shell Petroleum N.V. submits this brief *amicus curiae* for the primary purpose of placing before the Court the distinctive considerations applicable to a foreign parent company protected by the principles of strict territoriality of taxation embodied in various bilateral treaties, multinational conventions and international law which are relevant to the Court's disposition of this case. Shell Petroleum N.V. also supports the position taken in this appeal by Container Corporation.

SUMMARY OF ARGUMENT

The FTB's application of the unitary tax to the income of foreign affiliates of domestic corporations doing business in California violates the Foreign Commerce and Treaty-Making Powers Clauses of the U.S. Constitution, because such a method of taxation threatens Federal uniformity in the conduct of foreign relations and creates an impermissible risk of multiple taxation. The policies underlying the Foreign Commerce Clause are particularly important when the income sought to be taxed by a unitary apportionment formula is that of a foreign parent company and its primarily foreign subsidiaries because the perceived mistreatment of enterprises owned by foreign nationals or companies is most likely to result in adverse impacts on the United States' foreign relations.

Furthermore, the FTB violates the Due Process Clause of the United States Constitution by using a unitary tax to combine and apportion income when (i) there is no nexus between the taxing state and the interstate or foreign activities from which the income is derived and (ii) there is no rational relationship between the income attributed to the taxing state and the intrastate values of the enterprise. Under this Court's recent decision in *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. 4962 (U.S. June 29, 1982), the State of

California may not reach out to tax unrelated income earned elsewhere under the guise of "apportioning" such income to California where the result of its "apportionment" is to impose California taxes on the income earned abroad through the conduct of separate businesses by the foreign affiliates of a domestic corporation.

In addition, specific provisions of United States treaties with foreign countries and general principles of international law protect foreign companies affiliated with a domestic taxpayer from the practices of combination and apportionment pursued by the FTB in California. Foreign parent companies such as Shell Petroleum N.V. are entitled to the rights granted by such modern Friendship, Commerce and Navigation Treaties as the Treaty of 1956 between the United States and The Netherlands. That Treaty contains provisions incorporating the internationally accepted principle of strict territorial limitation on taxation. Those provisions, as well as certain additional protections and rights in that Treaty and others, have been violated by the FTB's application of California's unitary tax to the income of Shell Petroleum N.V. and its foreign affiliates.

ARGUMENT

The United States Constitution limits state taxation of the income of companies engaged in interstate and foreign commerce. In particular, the Foreign Commerce Clause, U.S. Const. art. I, § 8, cl. 3, the Treaty-Making Power, U.S. Const. art. II, § 2, cl. 2, and the Due Process Clause of the Fourteenth Amendment, U.S. Const. amend. XIV, § 1, require a state to limit its taxation to income related to the business activities conducted by the taxpayer within the state. Furthermore, international treaties establishing standards governing the taxation of foreign companies and their property, enterprises and interests, limit the taxing power of the FTB, since it has long been established that any state law inconsistent with a Federal treaty is preempted.

I. THE CALIFORNIA FRANCHISE TAX AS APPLIED VIOLATES THE UNITED STATES CONSTITUTION.

A. The Franchise Tax Board's Application Of The Unitary Tax Violates The Foreign Commerce Clause.

The FTB's application of the unitary tax formula to the income of foreign affiliates of domestic corporations doing business in California violates the Foreign Commerce Clause, U.S. Const. art. I, § 8, cl. 3, and the Treaty-Making Power, U.S. Const. art. II, § 2, cl. 2 of the United States Constitution under this Court's precedents, notably *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). This conclusion was endorsed by the United States Government, speaking through the Solicitor General, as *amicus curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, No. 81-349 (U.S. Sup. Ct.)[1] The United States Government further took the position that the policies underlying the Commerce Clause apply with even greater force in those situations in which the income sought to be apportioned and taxed by a state is that of a foreign parent company. *Id.* at 18-19.

The United States Constitution vests in the Federal Government the power to regulate foreign commerce and to make treaties. Crucial to the conduct of foreign affairs is federal uniformity—the ability of the government to speak with one voice. The United States and every other significant trading nation in the world taxes foreign corporations doing business within their territorial jurisdictions through a local subsidiary by treating the local subsidiary as an independent entity, determining the subsidiary's income on the basis of its separate accounts and looking to the foreign parent's accounts only when necessary to adjust transactions between parent and subsidiary to arm's-length values. This approach, commonly referred to as the arm's-length method, has not only been universally followed, but has also been adopted in numerous bilateral and

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[1] The Solicitor General and the Department of Justice filed an *amicus* brief in that case on behalf of the United States Government. Brief *amicus curiae* of the United States Government, *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349 (U.S., filed January 14, 1982) (hereinafter "U.S. Brief Amicus").

multilateral treaties, including the Modern Bilateral Convention for the Prevention of the Double Taxation of Income and Property (Mexico Draft 1943; London Draft 1946), the Model Double Taxation Convention on Income and on Capital, Organization for Economic Cooperation and Development (1977); the Model Double Taxation Convention Between Developed and Developing Countries, United Nations (1980); the Double Taxation Convention of 1948 between the United States of America and the Kingdom of The Netherlands, as amended; the Convention of Establishment of 1959 between the United States of America and France; the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands; and the Treaty of Friendship, Commerce and Navigation of 1946 between the United States of America and the Republic of China.

Application of a state formula-apportioned income tax to the income of foreign affiliates, conflicts sharply with the policies embodied in those treaties and more generally impairs the unity of policy necessary for the proper conduct of foreign affairs. The Solicitor General illustrates this conflict by means of a hypothetical example, in which a domestic corporation operating at a loss, and having no federal taxable income under the arm's-length method, falls subject to state taxation on foreign source income earned by foreign affiliates. *See* U.S. Brief Amicus, *supra,* at 2. This hypothetical situation has become a reality as a result of the FTB's actions. Through the application of the state franchise tax law, the FTB has determined that Scallop Nuclear earned some $46,000,000 in California income during the period 1973 through 1976, despite the fact that Scallop Nuclear actually lost some $390,000,000 during this period. With respect to Shell Oil, the FTB has apportioned to the State of California an amount equal to *92.6%* of Shell Oil's *total* income despite the fact that Shell Oil operated throughout the United States and in several foreign countries and had less than 20% of its sales, property and payroll (those being the relevant California apportionment factors) located in California.

The need for federal uniformity in conducting foreign affairs is particularly apparent when differing state and federal policies toward foreign countries prompt international protest, creating the potential for retaliation against the nation as a whole, not just against the state posing the conflict. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 450. Such a threat of retaliation is particularly pronounced where state officials are acting against a foreign parent company, because the interest of a foreign government in protecting the legitimate rights of its nationals is strongest in such a case.

During the past two years, the FTB's actions have stirred increasing complaints from the international community. On March 19, 1980, the Italian Government, acting on behalf of the European Economic Community ("EEC"), protested the FTB's actions to the United States Government. *See* Brief *amicus curiae* of the Kingdom of The Netherlands, *Shell Petroleum N.V. v. Graves, supra,* app. (N.D. Cal. filed March 22, 1982). On October 30, 1981, that protest was renewed by the United Kingdom on behalf of the EEC. On December 17, 1981, the Chancellor of the Exchequer of the United Kingdom protested to the Secretary of the Treasury and specifically asked that the United States Government address the issue in *Chicago Bridge*. *See* U.S. Brief Amicus, *supra,* app. The Governments of The Netherlands and Japan have voiced their opposition to the FTB's actions through their briefs amicus in *Shell Petroleum N.V. v. Graves, supra.* Brief *amicus curiae* of the Government of the Kingdom of The Netherlands, *supra;* Brief *amicus curiae* of the Government of Japan (N.D. Cal. filed May 17, 1982). Most recently, on June 29, 1982, the Government of Belgium, acting on behalf of the EEC, reiterated to the State Department the Community's opposition to the FTB's practice of combination and apportionment in the international sphere, terming it "entirely unsatisfactory".

In response to the request of the United Kingdom and after consultation with the Departments of State, Treasury and Commerce and the U.S. Trade Representative, the Solicitor General, speaking on behalf of the United States Government, has officially taken the position that application of a formula-apportioned state income tax to the worldwide income of a

multinational group of companies is constitutionally barred because it interferes with the Federal Government's need to speak with one voice in addressing this sensitive issue. In light of the growing concerns expressed by various foreign governments concerning the extraterritorial assertions of state tax power that conflict with federal policy, the Federal Government's expression of a need for uniformity in this area should be accepted by this Court as a sufficient basis, under *Japan Line,* to preclude the imposition of a formula-apportioned state income tax on the income of foreign affiliates as violative of the Foreign Commerce Clause.

A state tax is also unconstitutional under the Foreign Commerce Clause if it creates a substantial risk of multiple taxation in international commerce. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 446. Multiple taxation will necessarily occur when the income of foreign companies is generally taxed by the internationally accepted arm's-length method and the State of California applies formula apportionment to foreign source income. Appellant Container Corporation has demonstrated that the profitability of business operations outside the United States is normally greater. Consequently, the FTB's application of its three-factor apportionment formula to foreign source income will generally serve to import into California income already taxed abroad and thus result in multiple taxation, as it unquestionably has in the cases of Container Corporation and Shell Petroleum N.V. While the apportionment of income earned within the United States, under the supervision of this Court, can be monitored to avoid multiple taxation, quite the opposite results when foreign income is apportioned. The peculiar dangers posed by formula-apportioned taxes in matters of foreign commerce result from this Court's inability to ensure full and fair apportionment when one of the taxing entities involved is foreign. *Id.* at 447.

The burdens of multiple taxation can arise where the foreign company is a subsidiary, as in the case of Container Corporation. However, where the foreign company is the parent and its domestic subsidiary is relatively small compared to the overseas operations of the foreign parent and its foreign subsidiaries, the FTB's use of formula apportionment can have

particularly spectacular distorting effects because of the disproportionate profitability of foreign operations. Such is the case when the FTB seeks to apply the unitary apportionment formula to the income of a foreign parent, Shell Petroleum N.V., and its over 900 subsidiaries and affiliates operating worldwide. The FTB seeks to tax Scallop Nuclear on $46,000,000 of "apportioned" income when Scallop Nuclear in fact lost over $390,000,000. The FTB also seeks to impose its taxes on an amount equal to virtually all of Shell Oil's income (92.6%) during the period in question. Such gross distortion necessarily results in substantial multiple taxation, because the income of the foreign companies being combined, apportioned and then taxed has already been subject to and in fact taxed in the relevant foreign countries.

Furthermore, as the Solicitor General has noted, other burdens are placed exclusively on foreign commerce, in violation of the Foreign Commerce Clause, when a state seeks to consolidate the income of foreign affiliates with a domestic company, particularly when the foreign affiliate is the parent company. Requiring a foreign parent and its foreign affiliates to conform to U.S. accounting principles and California accounting rules and to convert all entries to U.S. dollars will be extremely burdensome to foreign commerce. U.S. Brief Amicus, *supra,* at 19. In addition, international commerce will be severely disadvantaged if massive reporting requirements are imposed on foreign companies. In its current proceedings against Shell Petroleum N.V.'s income, for example, the FTB has demanded the disclosure by Shell Petroleum N.V. and its over 900 worldwide subsidiaries and affiliates of their complete corporate histories and details of their individual businesses, such as the names of principal customers, revenues, profits and losses, and internal management structure. Those requirements pose severe and costly administrative burdens on foreign commerce. Those burdens are further enhanced where the foreign subsidiary of a foreign parent is engaged in business in a country sensitive to the release of such information, for in such a case the government involved may be particularly angered by intrusive informational demands of a subnational unit of a country in which neither the foreign subsidiary nor its parent has any permanent establishment or is engaged in

business. The imposition of these burdens, which are more pronounced in the case of a foreign parent company, constitutes a plain violation of the Foreign Commerce Clause of the U.S. Constitution.

B. The Franchise Tax Board's Application of the California Franchise Tax Violates the Due Process Clause.

The basic requirements of the Due Process Clause for state taxation of the income of a business operating in interstate or foreign commerce are now well established. This Court recently reiterated the "general principle [that] a State may not tax value earned outside its borders". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

In applying a unitary apportionment formula to income from without the state, a state is bound by two requirements of the Due Process Clause. First, there must be a "nexus" or "connection" between the interstate or foreign activities of the taxpayer and the taxing state. Second, there must be a "rational relationship between the income attributed to the State and the intrastate values of the enterprise". *See ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4964; *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. 207, 219-220 (1980); *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 436-37 (1980). The requirements of the Due Process Clause are *not* satisfied by a formula which combines and apportions all income that in some manner benefits or " 'adds to the riches of the corporation' ". *F. W. Woolworth Co. v. Taxation and Revenue Dep't of the State of New Mexico,* 50 U.S.L.W. 4957, 4959 (U.S. June 29, 1982), quoting *Wallace v. Hines,* 253 U.S. 66, 70 (1920).

The "nexus" required by the Due Process Clause for permissible state taxation of a business operating in interstate and foreign commerce is normally established if the corporation whose income is being taxed "avails itself of the 'substantial privileges of carrying on business' within the State". *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 200, quoting

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. at 435, 444-45. That nexus is clearly lacking when the FTB apportions the worldwide income of a foreign parent and its foreign subsidiaries, which did not themselves engage in business activities in the state during the taxing period. Where there are no such business activities within the state, the nexus requirement is satisfied only if "intrastate and extrastate activities [subject to formula apportionment] formed part of a *single unitary business". ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4964-65, quoting *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 438.

The essence of the unitary business principle, as this Court has defined the term, is the coordination and integration of various elements of the taxpayer's business in order to produce a stream of income for the taxpayer. *See, e.g., Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 223-26. Even if a taxpayer's intrastate and interstate or international activities are determined to constitute a "unitary business" generating a "unitary stream of income", *id.,* at 226, not all of the taxpayer's income is necessarily subject to apportionment. A state must exclude from the application of the unitary apportionment formula all income "derive[d] for 'unrelated business activity' which constitutes a 'discrete business enterprise' ". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4965, quoting *Exxon Corp. v. Wisconsin Dep't of Revenue,* 447 U.S. at 224, and *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 442, 439.

The FTB's actions with respect to Shell Petroleum N.V. cast additional light on the manner in which the FTB is disregarding both elements of the due process standard in pursuing foreign source income. The FTB has insisted on treating Shell Oil and Scallop Nuclear as unitary with Shell Petroleum N.V. despite its knowledge of the uncontroverted facts that Shell Oil and Scallop Nuclear operate businesses completely separate and independent from the businesses operated by other Royal Dutch/Shell companies abroad. Shell Oil is a major public company which operates under the direction

of its officers, none of whom are employees of Shell Petroleum N.V., and its Board of Directors, a majority of whom have during all relevant periods not been officers or directors of Shell Petroleum N.V. or any of its other affiliates.

The FTB's grounds for deeming Scallop Nuclear a part of a single unitary business comprising all of the businesses of all the 900 Royal Dutch/Shell companies are equally flimsy. For purposes of Scallop Nuclear, the FTB appears to rely on the simple fact of investment and ownership of stock in Scallop Nuclear. Scallop Nuclear's only business is that of General Atomic Company, a partnership in which Gulf Oil Corporation and Scallop Nuclear are equal 50% partners. The business of General Atomic is managed by its partnership committee in which Gulf Oil Corporation and Scallop Nuclear hold equal numbers of seats. Scallop Nuclear is not even engaged in the same type of business as any other Royal Dutch/Shell company, it being engaged in research activities directed toward the development of nuclear reactors.

The second requirement of the Due Process Clause is that there be a "rational relationship" between the income that is sought to be attributed to a state through the use of an apportionment formula and the "intrastate values of the enterprise" being taxed. A rational relationship is absent when the income apportioned and taxed is derived from discrete business enterprises that "have 'nothing to do with the activities' " of the company in the state, in " 'any business or economic sense' ". *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4968, quoting *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. at 439-42. Furthermore, a state's apportionment formula may not attribute to the state "income out of all appropriate proportion to the business transacted by the [taxpayer] in that State", *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 135 (1931).

The Franchise Tax Board, by misapplying the "unitary business" method of taxation to a misdefined notion of a "unitary business", has vastly overstated the alleged California income of companies doing business in California. For example, for the six-year period of 1967 through 1972, the FTB

claims as California's share approximately *92.6%* of the *total* income of Shell Oil from all sources. This figure bears no rational relationship to the California activities of Shell Oil, a company headquartered in Texas, doing business throughout the United States and in several foreign countries and having less than 20% of its property, sales and payroll located in California.

The FTB's claimed "portion" of Scallop Nuclear's income is even more irrational. During the years 1973-1976, the General Atomic partnership incurred aggregate losses of $780,218,000, of which Scallop Nuclear's share was one half, or $390,109,000.[2] Since Scallop Nuclear had no other business activities, those losses constituted its only "income" in California or elsewhere. The FTB, however, asserts that Scallop Nuclear earned approximately $46,000,000 in income in California for that four-year period, thereby fabricating approximately $436,000,000 of additional income. That California income figure bears no rational relationship to the business activities of Scallop Nuclear in California or indeed anywhere else.

The incredible distortions which thus arise from the FTB's application of its three-factor apportionment formula are the inevitable result of applying its apportionment formula to foreign source income. The essentially common economic conditions which may make formula apportionment an acceptable approach for purposes of allocating income derived from a unitary business operating in the United States do not apply to income produced by worldwide businesses. Vastly varying economic conditions render wholly unreasonable the assumption that like amounts of property, payroll and sales will generate like amounts of income. The application of the FTB's three-factor apportionment formula to foreign source income will therefore generally allocate to California income which bears no reasonable relation to the intrastate values involved. The FTB's attempts to reach this foreign income, like the efforts of the State Tax Commission of Idaho, are properly "viewed as

[2] For United States income tax purposes for those years Scallop Nuclear reported an aggregate loss of $273,268,967.

'a mere effort to reach profits earned elsewhere under the guise of legitimate taxation' ", *ASARCO Inc. v. Idaho State Tax Commission,* 50 U.S.L.W. at 4968, quoting *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271, 283 (1924), and therefore are clearly violative of the Due Process Clause of the U.S. Constitution.

II. THE FRANCHISE TAX BOARD'S ACTIONS WITH RESPECT TO FOREIGN SOURCE INCOME CONTRAVENE THE UNIVERSAL INTERNATIONAL ACCEPTANCE OF THE ARM'S-LENGTH METHOD AND REJECTION OF FORMULA APPORTIONMENT.

In addition to violating the Foreign Commerce and Due Process Clauses, the FTB's application of the unitary tax to the income of foreign companies violates numerous treaties between the United States and foreign countries and international conventions. Shell Petroleum N.V. is a company incorporated in The Netherlands and, therefore, is entitled to the protections of the Treaty of Friendship, Commerce and Navigation of 1956 between the United States and The Netherlands. That treaty is one of a series of such treaties entered into by the United States after World War II, generally referred to as the modern Friendship, Commerce and Navigation treaties.

As a matter of Federal constitutional law, U.S. Const. art. VI, cl. 2, the standards set out in those treaties are "the supreme law of the land". The treaties therefore limit the taxing power of the FTB, since it has long been established that any state law inconsistent with a Federal treaty is to that extent preempted. *See, e.g., Ware v. Hylton,* 3 U.S. (3 Dall.) 199 (1796); *Hauenstein v. Lynham,* 100 U.S. 483, 488-89 (1880); *Nielsen v. Johnson,* 279 U.S. 47 (1929); *United States v. Belmont,* 301 U.S. 324, 327, 331 (1937); *United States v. Pink,* 315 U.S. 203, 230 (1942).

The Treaty of Friendship, Commerce and Navigation between the U.S. and The Netherlands contains several provisions that proscribe the manner in which the FTB is applying its unitary tax formula. Article XI of the treaty specifically deals

with the taxation in one country of the companies of the other country. That article, *inter alia,* prohibits American governmental authorities from imposing any tax upon income "in excess of that *reasonably allocable or apportionable to* [*the*] *territories* [of the taxing authority]" (emphasis supplied).

Courts have long recognized that international treaties are based upon and informed by prevailing principles of international law. *See Geofroy v. Riggs,* 133 U.S. 258, 271 (1890). Accordingly, interpretation of modern Friendship, Commerce and Navigation treaties must be made in the context of the established international law and practice on which they are based.

The development of modern principles of international law applicable to assertions of national taxing powers derives from the work of the League of Nations. The position of the League, as set forth in early draft conventions, was that foreign companies doing business in the taxing country through a "permanent establishment" could be taxed only on the income "produced in" or "derive[d]" in the territories of the taxing state. *See* Modern Bilateral Convention for the Prevention of the Double Taxation of Income and Property, art. IV, para. 3; Protocol, art. VI, para. 1(A), (Mexico Draft 1943; London Draft 1946).[3] The income to be taxed "cannot exceed the earnings that are the direct result of the activities of the establishment concerned", *see* Commentary to Mexico and London Drafts at 17-18.

In order to determine what income was "derived" or "produced" within the taxing country, the League proposed reliance on the separate accounts of the permanent establishment, treating each permanent establishment as an independent enterprise. Income from transactions between the related enterprises was to be valued as if the transactions were between "independent persons dealing at arm's length", and the separate accounts of the permanent establishment could be

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[3] League of Nations Doc. C.88.M.88.1946.IIA: Fiscal Committee—London and Mexico Model Tax Conventions, Commentary and Text.

"rectif[ied]" "when necessary". Protocol, art. VI, para. 1(B)(Mexico Draft; London Draft).[4] *See also* Protocol, art. VII (Mexico Draft; London Draft).

The primary reason for the League's use of separate accounting as the "fundamental procedure for the determination of the profits attributable to each country in which an enterprise has an establishment" was that "it gives the taxation of branch establishments a strictly territorial scope not extending beyond the boundaries of the countries concerned". Commentary to Mexico and London Drafts at 18.

In addition to choosing separate accounting as the appropriate method for determining income derived within the taxing territory, the League's draft conventions forebade the consolidation or combination of the foreign parent company with its domestic subsidiary for tax purposes. Subsidiaries were not "permanent establishments" of the parent company for purposes of the draft conventions. Protocol, art. V, para. 8 (Mexico Draft; London Draft). Instead, subsidiaries were to be treated as independent enterprises. Accordingly, only the domestic subsidiary, not the foreign parent, could be taxed by virtue of the fact that such a subsidiary operated within the taxing jurisdiction. *See* Commentary to Mexico and London Drafts at 17.

The League's position with respect to international limitations on state taxation powers was adopted and continued by a number of international organizations in the postwar period, including those of which the United States is a member. Most notably, the Organization for European Economic Cooperation ("OEEC"), which subsequently became the Organization for Economic Cooperation and Development ("OECD"), has prepared draft conventions continuing the recognition of the international practice that only income derived by a permanent establishment within the taxing jurisdiction, as measured by the use of the arm's-length method and separate accounting, can be taxed.

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[4] This is the same legal standard employed by the United States, as reflected in § 482 of the Internal Revenue Code and accompanying Regulations.

In 1977, the Committee on Fiscal Affairs of the OECD issued its Model Double Taxation Convention on Income and on Capital ("1977 OECD Model Convention"). Under that Model Convention, as with other international model conventions, income of a parent corporation cannot be taxed in another country solely because a subsidiary is located in that other country. "The profits of an enterprise of a Contracting State shall be taxable only in that State *unless* the enterprise carries on business in the other Contracting State through a permanent establishment situated therein", art. 7, para. 1 (emphasis supplied), and a subsidiary does not constitute such a permanent establishment of the parent, art. 5, para. 7.

If such a permanent establishment exists, the taxing jurisdiction may tax only the profits "attributable" to that permanent establishment, art. 7, para. 1. If transactions between related companies have not been at arm's-length, as would have been the case had the companies been unrelated, the taxing jurisdiction may adjust the profits of the establishment to the arm's-length figure, art. 7, para. 2. However, such adjustments must always start with the "real facts" as they "appear from the business records of the permanent establishment", and be based on figures available in the open market. Commentary to art. 7.

The United Nations has adopted the same view of the accepted international law standards on taxation. *See, e.g.*, United Nations, *Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries* (7th Report, 1978). The United Nations' Group of Experts has specifically based its work on the efforts of the OECD, *id.* at 2, and has "unanimously recognized the validity of the arm's-length principle" in determining the profits of a permanent establishment for purposes of taxation of a multinational business. *Id.* at 62. *See generally* United Nations, *Model Double Taxation Convention Between Developed and Developing Countries* (1980).

The same principles have been adopted by the United States in its tax treaties with other nations, in recognition of the established international norm. The U.S.—Netherlands Double Taxation Convention of 1948, as amended, for example, specifically outlines the international approach of permanent establishments, separate accounting and arm's-length transactions in Article III, paragraphs 1 and 2.

The principles of strict territoriality of taxation, adopted by the numerous treaties and international conventions described above and constituting an integral part of international law, unquestionably prohibit the FTB's application of its practices of combination and apportionment to the income of Shell Petroleum N.V. and its foreign affiliates. Appellant Container Corporation, as a U.S. national, is of course not in a position to assert the rights vested in foreign nationals by these various treaties. However, Shell Petroleum N.V. submits that the pattern of these treaties and conventions is nonetheless relevant to the analysis of the constitutional issues raised by Container Corporation. Those treaties and conventions reflect universal acceptance of the arm's-length method of international taxation. The actions of the FTB in combining the income of Container Corporation with that of its foreign subsidiaries and apportioning the total income to California by application of its three-factor apportionment formula is plainly and unquestionably inconsistent with that universal practice. The universality of acceptance of the arm's-length method by the community of nations and its repeated reaffirmation by the United States lends strong support to the view, expressed by the Solicitor General in *Chicago Bridge*, that the need to speak with a single voice in matters of foreign commerce requires the prohibition under the Foreign Commerce and Treaty-Making Powers Clauses of the FTB's application of its principles of combination and formula apportionment where foreign source income is involved.

CONCLUSION

The FTB's application of the California unitary tax to the income of foreign affiliates of companies doing business in California violates the Foreign Commerce, Treaty-Making Powers and Due Process Clauses of the U.S. Constitution.

In any event, because of the special policy considerations applicable to the taxation of foreign companies under the U.S. Constitution, and the rights and protections accorded foreign companies by U.S. treaties and international conventions, this Court should not decide the case before it on grounds that would foreclose a foreign parent company from raising claims that the application of a unitary tax to foreign income violates the U.S. Constitution, U.S. treaties, and general principles of international law.

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